Note

More Equal than Others: Defending Property-Contract Parity in Bankruptcy

Blake Rohrbacher

CONTENTS

All animals are equal but some animals are more equal than others.[1]

[S]ome forms of property are worth more than others.[2]

INTRODUCTION

Imagine you own a successful donut shop, and an entrepreneur named Anthony Jenkins wants to franchise your idea and open a shop in a nearby city. You're worried that Anthony, who seems to have plenty of cash, might open some shops near you in the future. You request that a covenant not to compete be put in the franchise agreement. If Anthony refuses to sign a noncompete clause without a price reduction, how much less should you charge? If he does sign, how protected are you from Anthony's future encroachments?

Or, imagine you're Anthony's insurance company, and your contract explicitly says that you can cancel his fire policy if he doesn't maintain his shops' sprinkler systems. Have you charged enough in premiums to offset your risk? Are you really protected from Anthony's cavalier attitude toward sprinkler maintenance?

It all depends: How likely is it that Anthony will go bankrupt? Where could Anthony file for bankruptcy? Which bankruptcy judge will hear his case? These last three are questions you can't answer. Under current bankruptcy law, you can't, therefore, answer any of the previous questions.

While the common law has recognized property in contract for hundreds of years, bankruptcy law typically does not. Bankruptcy's distinction between property and contract is unjustifiable. It results in disparate treatment depending on what a given court terms a party's interest. This nominalist, form-over-substance reasoning can lead to inconsistent application of bankruptcy law, disregard for bankruptcy's fundamental principle of deference to nonbankruptcy entitlements, disruption of party expectations, and unequal treatment of interested parties in bankruptcy proceedings. Treating contractual property as regular property, I argue, would help rectify these problems and provide a normative policy justification that is lacking in much of bankruptcy law.

The property-contract approach detailed in this Note should improve the current system. Property-contract parity would lead to more efficient

1. GEORGE ORWELL, ANIMAL FARM 133 (New Am. Library 1996) (1946) (capitalization altered).

2. Pillow v. Avco Fin. Servs. (*In re* Pillow), 8 B.R. 404, 419 (Bankr. D. Utah 1981) (discussing the "most probable basis" for the distinction between secured and unsecured creditors).

contracting ex ante (i.e., before the debtor files for bankruptcy) and more efficient behavior ex post. One example of the current system's flaws is explored in Subsection III.B.3: For executory contracts in bankruptcy, the debtor's right to performance is treated as property, but the debtor's obligation to perform is treated as contract. Furthermore, bankruptcy courts are inconsistent in their treatment of executory contracts—for example, some courts hold that covenants not to compete are rejected in bankruptcy, while some do not. Thus, a party to a contract, who cannot know when or if the other party will file for bankruptcy, cannot be certain of the effect or permanence of his contract.

Ex ante, the current system results in less efficient contracting. When the parties first make their contract, they cannot predict which way a future bankruptcy court will rule. This uncertainty regarding the outcome and effect of contractual relationships precludes contracting parties from correctly calculating their gains and losses from the relationship. Thus, a creditor, or any party contracting with a potential debtor (i.e., virtually any contracting party), will have to charge higher prices, raising the price of doing business for the potential debtor. The uncertainty inherent in the current system also manifests itself in other ways, as seen in Subsection III.B.2: Nondebtors may find themselves stayed from asserting title to their property if they misjudge the bankruptcy court's future holdings. In the insurance context, this means that insurance companies may be barred from canceling policies under bargained-for cancellation clauses. Though there is some possibility that contracting parties can mitigate these inefficiency-causing wrinkles in the bankruptcy law by changing their behavior, the courts' inconsistencies, exacerbated in the current system, leave little guidance for adaptation. When bankruptcy courts hold either that noncompete covenants are rejected or are not, for example, parties cannot efficiently adapt to prevailing law.

Ex post, the current system also results in inefficient behavior. According to Thomas Jackson, the role of bankruptcy law is to prevent the collective action problems that might result from a race by creditors to grab a bankrupt debtor's assets.[3] Thus, "bankruptcy law should not create rights. . . . [but] should act to ensure that the rights that exist are vindicated to the extent possible."[4] The inefficiency caused by the current system emerges when one party receives better treatment within bankruptcy than without. This differential treatment can distort incentives to file or not file for bankruptcy, with the possible result of destroying value through the

3. *See* THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 5 (photo. reprint 2001) (1986).

4. *Id*. at 22.

process.[5] Property-contract parity should make bankruptcy outcomes more consistent with nonbankruptcy outcomes and minimize this inefficient distortional effect on behavior.

In Part I, I examine the relationship between property and contract. First, I look at what distinguishes the two. Then, I discuss the chose in action, a historical intersection of property and contract. Last, I create a definition for identifying and separating contract and property.

In Part II, I study the property-contract distinction as it currently exists under bankruptcy law. Then, I test the oft-proffered reasons for the distinction, showing why these reasons are unpersuasive.

In Part III, I propose an approach of property-contract parity in bankruptcy. Applying it to three areas of bankruptcy law, I show in Section III.B how property-contract parity could improve the treatment of landlords' remedies against bankrupt tenants, the automatic stay as applied to insurance contracts and government licenses, and executory contracts. In each of these areas, bankruptcy courts' different treatment of contract and property currently leads to inequitable and inconsistent results, while following property-contract parity would lead to more consistent decisions and a more optimal balance of rights for debtors and creditors.

I. DEFINING RIGHTS IN PROPERTY AND CONTRACT

It is difficult to define the relationship between property and contract. Some commentators suggest that the two overlap.[6] Others consider them closely related parts of the common law triumvirate, along with tort.[7] Still others resist the notion that they occupy common ground, while recognizing that they do often work together.[8]

Before examining bankruptcy through the lens of the property-contract intersection, we must consider how property and contract differ and how they intersect. The first Section briefly surveys the usual categorical definitions of property and contract. The next Section examines choses in action, which demonstrate the interrelationship between property and contract. The third Section builds on existing scholarship to advance a description of property and contract that serves as the foundation for Part III's bankruptcy analysis. Thus, I will examine how property and

5. *Cf. id.* at 61-63.

6. *See, e.g.*, Henry Hansmann & Reinier Kraakman, *Property, Contract, and Verification: The* Numerus Clausus *Problem and the Divisibility of Rights*, 31 J. LEGAL STUD. S373, S392 (2002).

7. *See, e.g.*, RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 31 (6th ed. 2003).

8. *See, e.g.*, J.E. PENNER, THE IDEA OF PROPERTY IN LAW 5 (1997) ("[P]roperty is not wedded to contract in any way, ... so bargains with respect to property do not slip into the ambit of property . . . .").

contract differ, how they overlap, and how these two principles can be reconciled.

A. *Property or Contract: Distinguishing Features*

While the exact relationship between property and contract is not often discussed,[9] scholars who do consider the two tend to view them as fundamentally different—if not opposite—in a number of ways. One oft-proposed difference between property and contract is that property is concerned with "creating and defining property rights," while contract is concerned with "facilitating the voluntary movement of property rights" from lower-valuing to higher-valuing users.[10] Contract is also defined as including "all promises that the law will enforce."[11] In this sense, the distinction between property and contract is that property is about a person's right to a thing, and contract is about promises to transfer those rights from one person to another.

Some writers point to the "freedom to 'customize' legally enforceable interests" as a key difference between the two.[12] The law of contract is virtually unlimited in its ability to create legally binding contracts of varying lengths, natures, and subjects, while property rights can be held only in a limited number of fixed forms[13] (the familiar litany, including fee simple, life estate, reversion, and remainder).

In 1917, Wesley Newcomb Hohfeld set out a framework for the fundamental differences between contract and property, analyzing the underlying rights of each.[14] Hohfeld denoted rights held by a person against one or a few definite persons as "paucital" rights, or rights in personam, and rights held by a person against a "very large and indefinite class of people" as "multital" rights, or rights in rem.[15] These multital rights are made up of

9. *See* Thomas W. Merrill & Henry E. Smith, *The Property/Contract Interface*, 101 COLUM. L. REV. 773, 775 (2001) ("Given the high stakes and the contested terrain, it is surprising how little attention has been given to the fundamental characteristics that distinguish property and contract as legal institutions."). In a typical property casebook, contracts are only mentioned in conjunction with leases or dispositions of property. *See, e.g.*, JESSE DUKEMINIER & JAMES E. KRIER, PROPERTY 1257 (5th ed. 2002).

10. POSNER, *supra* note 7, at 31.

11. Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 543 (2003).

12. Thomas W. Merrill & Henry E. Smith, *Optimal Standardization in the Law of Property: The* Numerus Clausus *Principle*, 110 YALE L.J. 1, 3 (2000).

13. *Id.*; *see also* Merrill & Smith, *supra* note 9, at 776.

14. WESLEY NEWCOMB HOHFELD, *Fundamental Legal Conceptions as Applied in Judicial Reasoning, in* FUNDAMENTAL LEGAL CONCEPTIONS AS APPLIED IN JUDICIAL REASONING 65 (photo. reprint 2000) (Walter Wheeler Cook ed., 1919) [hereinafter ESSAYS].

15. *Id.* at 72.

a great number of similar but separate paucital rights.[16] Contract is exemplified by paucital rights, which bind only the parties to the contract, and property by multital rights, which bind the whole world.[17]

J.E. Penner's definition of property turns on other elements:[18] Property is "the interest in exclusively determining the use of things," while contracts are "exchanges."[19] Just because contracts often deal with property does not mean, according to Penner, that "property and contract are intrinsically linked, or that one is the basis of the other."[20]

Guido Calabresi and Douglas Melamed's famous 1972 article said that a legal entitlement is protected by a "property rule" when "someone who wishes to remove the entitlement from its holder must buy it from him in a voluntary transaction."[21] Penner recognizes that property has an "element of alienability," but he states that "property does not depend on the existence of a right to create binding agreements."[22] Nor do contracts, he continues, "depend on property rights," because there "can be any number of contracts with objects that are not property."[23]

In summary, property and contract have been seen as fundamentally distinct on several axes. Some commentators sense, nonetheless, that contract and property are very closely related, or at least blend together. Thomas Merrill and Henry Smith acknowledge that "it is often difficult to say where the one starts and the other leaves off."[24] Henry Hansmann and Reinier Kraakman see even less to distinguish the two, characterizing them

16. *Id*. at 73.

17. *See* Merrill & Smith, *supra* note 9, at 776-77. Merrill and Smith expand this concept, separating the numerosity of dutyholders (persons against whom the rights are held) from the definiteness of those dutyholders. *See id*. at 785. Thus, the two poles are contract rights that are "definite and singular" (pure paucital rights) and property rights that are "indefinite and numerous" (pure multital rights). *Id*. In between, Merrill and Smith identify "compound-paucital" contract rights, which are definite and numerous, and "quasi-multital" contract rights, which are indefinite and singular. *Id.* (internal quotation marks omitted).

18. *See, e.g*., PENNER, *supra* note 8, at 23 (stating that Hohfeld's work was "responsible for enthralling a generation of legal scholars with a bad, though appealing, characterization of the distinction" between in rem and in personam rights); *id*. at 24 (stating that the effect of Hohfeld's view on this matter "has been persistent, even among those who recognize that something is wrong with it"). Penner, opposing Hohfeld, argues that property can also be a right in personam: If Ann grants Bill a license to cross her farm, Bill is a definite, singular rightholder with respect to property. *Id*. at 26.

19. *Id*. at 49, 51.

20. J.E. Penner, *The "Bundle of Rights" Picture of Property*, 43 UCLA L. REV. 711, 752 (1996). Penner argues that this "single misconception has probably done more to confuse the understanding of both subjects than anything else." *Id*. at 752-53.

21. Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1092 (1972).

22. Penner, *supra* note 20, at 753.

23. *Id*. ("'If you scratch my back, I'll scratch yours,' for instance.").

24. Merrill & Smith, *supra* note 9, at 774.

as "just two different means of coordinating parties' expectations" that "merge into each other" at the margins.[25]

B. *Property in Contract: Choses in Action*

The features summarized in Section A that purport to distinguish contract and property work best when applied to instances of contract and property at the far ends of the spectrum. When the two get closer, however, these distinctions do not hold up. One intertwining of contract and property is the chose in action, defined as the "right to bring an action to recover a debt, money, or thing."[26] Choses in action refer to "rights under a contract," as well as to causes of action "arising from breach of contract,"[27] and choses in action are personal property.[28] Therefore, rights under a contract are themselves property.[29]

The property component of the chose in action is linked to the property that a rightholder would win in a suit. For example, if Ann has a contract with Bill under which he owes her $100, her chose in action is the right to recover that $100. The $100 is property, whether it is in cash or securities or some other form of property (like stereo equipment or furniture), but it is in Bill's possession at the moment. Although Ann does not currently have possession of the $100, the chose in action refers to the fact that, once she takes him to court and gets a judgment, the $100 will eventually pass to her. Thus, the chose in action looks toward a future state of potential possession: Ann may get the $100, either through Bill's performance or through resort to the judicial process, so the law deems her ownership of the $100 as being as good as done.[30] Of course, she does not have present ownership rights over the $100, but only rights against Bill, for which she can get legal

25. Hansmann & Kraakman, *supra* note 6, at S392. Penner's view is that "the way in which property and contract have been mistakenly intertwined" has led to an "unfortunate misdescription of both," but he admits that he is "rather alone on this point" in the "world of property theorizing." PENNER, *supra* note 8, at 5.

26. BLACK'S LAW DICTIONARY 258 (8th ed. 2004).

27. WILLIAM R. ANSON, PRINCIPLES OF THE LAW OF CONTRACT 362 n.b (Arthur L. Corbin ed., 3d Am. ed. 1919).

28. *See, e.g.*, Gregory v. Colvin, 363 S.W.2d 539, 540 (Ark. 1963).

29. In a bankruptcy context, for example, the Second Circuit held that a debtor's interest in "commissions on renewal premiums . . . pursuant to the terms of [a] contract" was property. *In re* Wright, 157 F. 544, 545, 545-46 (2d Cir. 1907).

Choses in action were recognized as far back as Blackstone, who described the chose in action as "where a man hath not the occupation, but merely a bare right to occupy the thing in question; the possession whereof may however be recovered by a suit or action at law." 2 WILLIAM BLACKSTONE, COMMENTARIES *396. Although he only has the right to (and not the possession of) the property subject to the chose in action, "the owner may have as absolute a property of such things in action, as of things in possession." 2 *id*. at *397-98.

30. *See* Penner, *supra* note 20, at 811.

enforcement.[31] Property is either a thing that is possessed now or can be possessed in the future by the working of legal action, so the rights held by parties under contracts (which are enforceable at law) are property.[32]

C. *Property and Contract: Intersections and Implications*

None of the differences examined in Section A are completely satisfactory for distinguishing property from contract, especially when choses in action occupy both camps. Property is limited to a few standard forms, and contract can take an infinite variety of forms, but from a practical standpoint, "[c]omplex estates in contract rights—such as future interests—do not seem to exist."[33] Property comprises in rem rights held against the world, and contract comprises in personam rights against other contracting parties. Choses in action are not in rem rights, however, but "rights in personam held against specifiable individuals."[34] Property is the interest in the exclusive use of a thing, and contract simply the interest in bargaining. Contract, though, also has an element of exclusive use, because contract rights, "like property rights, are 'good against all the world' inasmuch as any third party who intentionally interferes with a contractual right commonly faces liability for tortious conduct to the holder of the right."[35]

Courts and legislatures have recognized the great extent to which contracts can be property: Opportunities to buy an equity interest in a

31. Howard W. Elphinstone, *What Is a Chose in Action?*, 9 LAW Q. REV. 311, 313 (1893).

32. *See, e.g.*, Cont'l Ill. Nat'l Bank & Trust Co. v. Chi., Rock Island & Pac. Ry. Co., 294 U.S. 648, 680 (1935) (discussing a bankruptcy provision that "deprives [the parties] of their property—that is to say, impairs or destroys their contractual rights"); LTV Corp. v. Aetna Cas. & Sur. Co. (*In re* Chateaugay Corp.), 116 B.R. 887, 898 (Bankr. S.D.N.Y. 1990) ("Contractual rights are intangible property . . . ."); Yuba River Power Co. v. Nev. Irrigation Dist., 279 P. 128, 129 (Cal. 1929) (defining "property" to "embrace those rights which lie in contract—those which are executory as well as those which are executed" (internal quotation marks omitted)).

Legislatures have followed this principle as well. *See* MODEL PENAL CODE § 223.0(6) (Official Draft 1962) (defining "'property'" to include "contract rights" and "choses-in-action").

33. Merrill & Smith, *supra* note 12, at 55.

34. PENNER, *supra* note 8, at 107-08 (italics omitted).

35. Hansmann & Kraakman, *supra* note 6, at S410. "One who intentionally and improperly interferes with another's prospective contractual relation . . . is subject to liability to the other for the pecuniary harm resulting from loss of the benefits of the relation . . . ." RESTATEMENT (SECOND) OF TORTS § 766B (1979). Further, one British case held that a chose in action could be stolen, *see* Chan Man-sin v. Attorney Gen., [1988] 1 All E.R. 1, 3-4 (Eng. P.C. 1987) (appeal taken from H.K.), something that might only happen to property.

company are property,[36] as are insurance policies[37] and rights to indemnity.[38]

Contract and property also have been linked in many constitutional contexts. Contracts have long been held to be constitutional property under the Takings Clause.[39] Causes of action have a history of treatment as property for due process purposes,[40] and, because they are causes of action, contractual rights fall under the protection of the Due Process Clause as well.[41] At least one circuit has held that a contractual right can be property, protected by due process;[42] the Supreme Court has held that an employment contract can be treated as constitutional property;[43] and most commercial contracts would qualify as property under the Due Process Clause.[44]

36. *See* Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 455 (1999).

37. *See, e.g.*, Legg v. St. John, 296 U.S. 489, 495 (1936); John H. Langbein, *The Nonprobate Revolution and the Future of the Law of Succession*, 97 HARV. L. REV. 1108, 1110 (1984).

38. *See* Phelps v. McDonald, 99 U.S. 298, 304 (1878).

39. *See, e.g.*, Lynch v. United States, 292 U.S. 571, 579 (1934) ("Valid contracts are property [under the Fifth Amendment], whether the obligor be a private individual, a municipality, a State or the United States."); Omnia Commercial Co. v. United States, 261 U.S. 502, 508-09 (1923) ("The contract in question was property within the meaning of the Fifth Amendment, and if taken for public use the Government would be liable. . . . Contracts in this respect do not differ from other kinds of property." (citations omitted)); Muhlker v. N.Y. & Harlem R.R. Co., 197 U.S. 544, 570 (1905) ("[H]is easements of light and air were secured by contract . . . and could not be taken from him without payment of compensation.").

Merrill's take on contracts under the Takings Clause meshes well with my property-contract definition, discussed later. "Property for Takings Clause purposes should not be construed in such a broad fashion that it automatically includes all contract rights." Thomas W. Merrill, *The Landscape of Constitutional Property*, 86 VA. L. REV. 885, 990 (2000). Some contract rights are unquestionably constitutional property: most choses in action, "bonds, common stock, and even money issued by the government." *Id*. at 993. Some contract rights, however, do not satisfy the property requirement of the Takings Clause: "Contract rights are not property for takings purposes insofar as they reflect nothing more than a bilateral agreement; as contract rights break free from the initial contracting parties and enter into general circulation as investments or money, they become property." *Id*. at 993-94.

40. *Cf.* Logan v. Zimmerman Brush Co., 455 U.S. 422, 430-31 (1982); Mullane v. Cent. Hanover Bank & Trust Co., 339 U.S. 306, 313 (1950).

41. *See* Leonard Kreynin, Note, *Breach of Contract as a Due Process Violation: Can the Constitution Be a Font of Contract Law?*, 90 COLUM. L. REV. 1098, 1107 (1990) ("More than any other species of property short of realty and personalty, contract interests definitionally fall within the due process clause's protection. . . . , [because] they are always a step away from being converted into indisputable property interests such as money . . . .").

42. *See, e.g.*, Mertik v. Blalock, 983 F.2d 1353, 1360 (6th Cir. 1993).

43. *See* Perry v. Sindermann, 408 U.S. 593, 603 (1972). *But see* Brown v. Brienen, 722 F.2d 360, 364 (7th Cir. 1983) ("[T]here is no rule that every breach of a public employment contract is a deprivation of property within the meaning of the due process clause.").

44. Merrill, *supra* note 39, at 994-95. *But cf.* S & D Maint. Co. v. Goldin, 844 F.2d 962, 966 (2d Cir. 1988) (stating that an "interest in enforcement of an ordinary commercial contract with a state is qualitatively different from the interests the Supreme Court has thus far viewed as 'property' entitled to procedural due process protection" in discussing contracts made with a state, rather than private commercial contracts).

How then to best define the difference between contract and property? Property comprises rights held at the mercy of law (and society), and contract comprises rights held at the mercy of another person.[45]

Property deals with rights held at the mercy of the law and society. There are two ways to understand this: We could say that law creates property rights or that it "merely recognizes and perfects" property.[46] This is a chicken-and-egg philosophical debate that I do not enter because both of these views are acceptable under the definition I use. Some feel that law creates property; in constitutional law, the "hallmark of property" is an "individual entitlement grounded in state law."[47] Some feel that law simply formalizes the preexisting characteristics of property; "rights are not in reality property either in action or in possession, but are merely *vincula juris* [the bonds of law] by which property and persons are bound together."[48] Both fit my definition: Property is defined by our society and our law, which each stand behind it and make the property rights binding and good against the world.

Contract, on the other hand, embodies two different concepts: the agreement between the parties and the obligations created by the contract.[49]

45. To understand the meaning and operation of this definition, consider, as two polar examples, (1) a bilateral double personal-service contract and (2) land. A double personal-service contract would be, for these purposes, one in which each party has a personal-service obligation to the other. Using the most common exemplars of personal-service contracts (opera singers and great painters), we could imagine that Pavarotti agreed with Michelangelo on the following: Pavarotti will sing an aria at Michelangelo's next dinner party, and Michelangelo will paint a mural on Pavarotti's bedroom wall.

A double personal-service contract contains no rights that can be bought or sold. 6 AM. JUR. 2D *Assignments* § 28 (1999). In most cases, parties to such a contract would not be able to get a court to force performance. 71 AM. JUR. 2D *Specific Performance* § 182 (1999). To be sure, Pavarotti could sue for damages, but then he would simply be suing on the chose-in-action portion of the contract, which is, as discussed above, considered property. A party to a double personal-service contract instead has to depend on the other party for fulfillment of his bargain.

Our law, of course, recognizes property in land. Title registration systems maintain the lists of owners of that land. *See generally* C. Dent Bostick, *Land Title Registration: An English Solution to an American Problem*, 63 IND. L.J. 55, 62-74 (1987). People can buy and sell land; landowners have the right to sue those who trespass, 87 C.J.S. *Trespass* § 30 (2000); and courts will enjoin nuisances that harm the use of land, 66 C.J.S. *Nuisances* § 92 (2000).

46. Alan Brudner, *The Unity of Property Law*, 4 CANADIAN J.L. & JURISPRUDENCE 3, 16 (1991). For example, Charles Reich wrote that property "is the creation of law." Charles A. Reich, *The New Property*, 73 YALE L.J. 733, 739 (1964); *see also* Ernest J. Weinrib, *The Fiduciary Obligation*, 25 U. TORONTO L.J. 1, 10 (1975) ("[P]roperty is itself merely the label for that crystallized bundle of economic interests which the law deems worthy of protection.").

47. Logan v. Zimmerman Brush Co., 455 U.S. 422, 430 (1982); *see also* Frank I. Michelman, *Property, Federalism, and Jurisprudence: A Comment on* Lucas *and Judicial Conservatism*, 35 WM. & MARY L. REV. 301, 305 (1993) ("[T]he term 'property' in the Fourteenth Amendment denotes nothing except what some corpus of extant positive law happens to make into property.").

48. Spencer Brodhurst, *Is Copyright a Chose in Action?*, 11 LAW Q. REV. 64, 70 (1895).

49. *See* Omnia Commercial Co. v. United States, 261 U.S. 502, 511 (1923) (stating that a "contract consists in the agreement and obligation to perform"); *cf.* U.C.C. § 1-201(b)(12) (2004) (distinguishing "contract" from "agreement" and defining a contract as "the total legal obligation that results from the parties' agreement . . . as supplemented by any other applicable laws").

This distinction was seen by Blackstone in the 1760s[50] and by Hohfeld in 1913,[51] and it is still seen today.[52] The difference between agreement and obligation makes a difference: It matters in the context of whether an offer is valid[53] or whether the Contracts and Takings Clauses apply.[54] *Aycock v. Martin* made explicit this distinction in the Contracts Clause context, stating that a "contract" and an "obligation of the contract" are different things: "The *terms* of the contract are made alone by the parties to the agreement. The *obligation* is the creature of law,—is the law existing when the contract is made, binding to the performance of the promise, and is furnished solely by society."[55] This difference between the agreement and the contractual obligations is the difference between property and contract. The U.S. Supreme Court, per Chief Justice Marshall, explained the difference by stating that a "contract is an *agreement*, in which a party undertakes to do, or not to do, a particular thing. The law binds him to perform his undertaking, and this is, of course, the *obligation* of his contract."[56]

The essence of my property-contract definition is that the true distinction is not between contract and property (as commonly understood), but rather between property and contractual obligations on one hand and the contract agreement on the other. The contractual obligation is property. To restate the definition I gave above, property, including contractual obligations, comprises rights held at the mercy of law, while contract, meaning the contractual agreement, comprises rights held at the mercy of

50. *Compare* 2 BLACKSTONE, *supra* note 29, at *442 ("A contract . . . is thus defined: an agreement, upon sufficient consideration, to do or not to do a particular thing." (capitalization altered) (internal quotation marks omitted)), *with* 2 *id*. at *397 ("[A]ll property in action depends entirely upon contracts, either express or implied; which are the only regular means of acquiring a chose in action . . . ." (emphasis omitted)).

51. WESLEY NEWCOMB HOHFELD, *Some Fundamental Legal Conceptions as Applied in Judicial Reasoning*, *in* ESSAYS, *supra* note 14, at 23, 31 (stating that we must "discriminate between the mental and physical facts involved in the so-called 'agreement' of the parties, and the legal 'contractual obligation' to which those facts give rise"). Hohfeld lamented the confusion created by not recognizing this distinction. *Id*.

52. BLACK'S LAW DICTIONARY, *supra* note 26, at 341 (defining "contract" as an "*agreement* between two or more parties *creating obligations* that are enforceable or otherwise recognizable at law" (emphasis added)).

53. *See, e.g.*, Brauer v. Shaw, 46 N.E. 617, 617 (Mass. 1897) (Holmes, J.) ("By their choice and act, they brought about a relation [agreement] between themselves and the plaintiffs, which the plaintiffs could turn into a contract [obligation] by an act on their part . . . ."); HOHFELD, *supra* note 51, at 55-56.

54. *See, e.g.*, Aycock v. Martin, 37 Ga. 124 (1867) (Contracts Clause); Merrill, *supra* note 39, at 993-94 (Takings Clause).

55. *Aycock*, 37 Ga. at 143 (opinion of Harris, J.) (emphasis altered).

56. Sturges v. Crowninshield, 17 U.S. (4 Wheat.) 122, 197 (1819) (Marshall, C.J.) (emphasis added).

another person. This framework will serve as the lens through which I view bankruptcy law in Part III.[57]

II. THE PROPERTY-CONTRACT DISTINCTION IN BANKRUPTCY

A. *Current Law*

Having developed a working model for distinguishing contract and property, I next examine how previous conceptions of property and contract have affected and been affected by bankruptcy law. I briefly describe the different treatment given to property and contract in bankruptcy law and, in Section B, study some of the possible reasons for this different treatment.

Contract and property are treated differently in bankruptcy: Bankruptcy typically impairs contract rights but mostly leaves property rights alone.[58] For something seen as contract, for example, the debtor can breach (i.e., reject) it in bankruptcy,[59] with any damages treated as a pre-petition claim.[60] Property, on the other hand, is respected,[61] and adequate protection must be given for it.[62] In other words, "'property rights' survive rejection, but 'contract rights' do not."[63] Also, while property rights receive adequate protection, the value of a contractual right depends greatly on whether the trustee assumes or rejects the contract. If the trustee assumes the contract,

57. Because of the property-contract definition I am employing, much of my argument will involve the recharacterization of "contract" as property. This Note deals almost exclusively with business bankruptcy, as opposed to consumer bankruptcy. Most commercial contracts qualify as property under my definition. Merrill, *supra* note 39, at 995.

58. *See, e.g.*, Kuehner v. Irving Trust Co., 299 U.S. 445, 451-52 (1937) ("[T]here is, as respects the exertion of the bankruptcy power, a significant difference between a property interest and a contract . . . ."); *In re* Marshall, 300 B.R. 507, 525 (Bankr. C.D. Cal. 2003) (same); Marvin Garfinkel, *Summary of Certain Issues Regarding Section 365 Rejection of All or Portions of Covenants That Run with the Land*, C845 A.L.I.-A.B.A. 425, 428 (1993) ("The problem is to differentiate between 'contract rights' which may be rejected under section 365 and 'property rights' which should not be subject to Section 365 rejection."); Jay Lawrence Westbrook, *The Commission's Recommendations Concerning the Treatment of Bankruptcy Contracts*, 5 AM. BANKR. INST. L. REV. 463, 472 (1997) ("Ordinarily, bankruptcy law does not affect property rights, as opposed to contract rights . . . .").

59. 11 U.S.C. § 365(a) (2000).

60. *Id.* § 365(g). Section 365(g) ensures that damages arising from a breach of contract that happens after filing are treated as if the breach had happened before filing.

61. Edward J. Janger, *Muddy Property: Generating and Protecting Information Privacy Norms in Bankruptcy*, 44 WM. & MARY L. REV. 1801, 1810 (2003).

62. 11 U.S.C. §§ 361, 362(d)(1). Adequate protection is the requirement that the bankruptcy estate maintain the value of a creditor's property.

63. Michael T. Andrew, *Executory Contracts in Bankruptcy: Understanding "Rejection,"* 59 U. COLO. L. REV. 845, 922 (1988) [hereinafter Andrew, *Contracts*]. "Rights in property that arise from a contract may, however, be terminated by bankruptcy law's normal avoiding powers." Michael T. Andrew, *Executory Contracts Revisited: A Reply to Professor Westbrook*, 62 U. COLO. L. REV. 1, 17 (1991) [hereinafter Andrew, *Reply*].

the right becomes a claim payable in "full, 100 cent U.S. dollars."[64] If the contract is rejected, on the other hand, the right is simply an unsecured claim payable in "little tiny Bankruptcy Dollars," which reflect the pro rata payout per dollar.[65] The different treatment of contract and property has even been used to distinguish between rights held by a single person. The Supreme Court has stated that, in bankruptcy, the "contractual right of a secured creditor to obtain repayment of his debt may be quite different in legal contemplation from the property right of the same creditor in the collateral."[66]

This axiom of bankruptcy is not without exception, however: Property is not untouchable, and contracts do have some protection. Some commentators note that bankruptcy can disturb property rights through its avoiding powers.[67] The combination of the automatic stay[68] and the concept of adequate protection (after the Supreme Court's decision in *Timbers*[69]) together show that bankruptcy does not fully honor a secured creditor's in rem rights.[70] Some courts suggest that bankruptcy courts have less power now than they once did to meddle with contracts.[71] Others suggest that property rights are just as subject to alteration in bankruptcy as contract rights. The Supreme Court made clear in 1938 that property rights "do not gain any absolute inviolability in the bankruptcy court because [they are] created and protected by state law."[72] Although most property rights are "created and protected" by state law, the Court stated that Congress, acting within the bankruptcy power, could "authorize the bankruptcy court to affect these property rights, provided the limitations of the due process clause are observed."[73]

One area where contracts are treated as being on par with property is in determining what is property of the bankruptcy estate. The Code provides

64. Jay Lawrence Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227, 253 (1989).

65. *Id.*

66. United States v. Sec. Indus. Bank, 459 U.S. 70, 75 (1982).

67. *See, e.g.*, Westbrook, *supra* note 58, at 472. For this point, I thank Mitzi, Case, and Keally.

68. 11 U.S.C. § 362 (2000). The stay keeps secured creditors from foreclosing on their collateral after the debtor files for bankruptcy.

69. United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs., 484 U.S. 365 (1988) (denying a secured creditor the right to compensation for the delay in foreclosure caused by the automatic stay).

70. Margaret Howard, *Equipment Lessors and Secured Parties in Bankruptcy: An Argument for Coherence*, 48 WASH. & LEE L. REV. 253, 258 (1991); *cf. In re* 620 Church St. Bldg. Corp., 299 U.S. 24, 27 (1936).

71. *See, e.g.*, Kham & Nate's Shoes No. 2 v. First Bank of Whiting, 908 F.2d 1351, 1361 (7th Cir. 1990).

72. Wright v. Union Cent. Life Ins. Co., 304 U.S. 502, 518 (1938).

73. *Id.*; *see also* Pillow v. Avco Fin. Servs. (*In re* Pillow), 8 B.R. 404, 424 (Bankr. D. Utah 1981).

that "all legal or equitable interests of the debtor in property as of the commencement of the [bankruptcy] case" are property of the bankruptcy estate.[74] The scope of this section was designed to be broad;[75] it includes choses in action,[76] which include rights of action based on contracts.[77] Even an interest in a contract that has "value" and is "contingent at the time of filing and not payable" until termination is property of the estate under § 541(a)(1).[78] Courts have held that contractual rights,[79] executory contracts,[80] and memberships[81] are property of the estate. Even contractual transfer restrictions do not keep property interests from being considered property of the estate.[82]

Regardless, contract and property are typically treated differently in bankruptcy.[83] Especially because the bankruptcy courts are open to allowing contractual rights to serve as "property interests" under § 541 but are unwilling to treat contract and property as being on par in other areas, it is not surprising to see commentators complaining about the persistence of the property-contract disparity.[84]

There is a difference in bankruptcy's treatment of property and contract, but, if creditors can simply foresee these issues and bargain around the difference, does it really matter that there is one? Analysis shows that it does matter. First, the U.S. bankruptcy system contains

74. 11 U.S.C. § 541(a)(1) (2000).

75. United States v. Whiting Pools, 462 U.S. 198, 205 (1983); H.R. REP. NO. 95-595, at 367 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6323 ("The scope of this paragraph is broad. It includes all kinds of property, including tangible or intangible property, [and] causes of action . . . ."). In *Segal v. Rochelle*, which Congress followed in crafting § 541, the Supreme Court stated that "the term 'property' has been construed most generously and an interest is not outside its reach because it is novel or contingent or because enjoyment must be postponed." 382 U.S. 375, 379 (1966).

76. Slater v. Town of Albion (*In re* Albion Disposal), 217 B.R. 394, 402 (W.D.N.Y. 1997); H.R. REP. NO. 95-595, at 175, *reprinted in* 1978 U.S.C.C.A.N. 5963, 6136.

77. Rau v. Ryerson (*In re* Ryerson), 739 F.2d 1423, 1425 (9th Cir. 1984).

78. *Id.* In addition, any payments made at termination of the contract are also considered property of the estate to the extent they are related to "prebankruptcy services." *Id.*

79. *E.g.*, Legg v. St. John, 296 U.S. 489, 493 (1936); LTV Corp. v. Aetna Cas. & Sur. Co. (*In re* Chateaugay Corp.), 116 B.R. 887, 898 (Bankr. S.D.N.Y. 1990); *see also* JACKSON, *supra* note 3, at 107 (stating that a debtor's right to receive goods under a contract that is no longer contingent on the debtor's performance is property of the estate).

80. Cohen v. Drexel Burnham Lambert Group (*In re* Drexel Burnham Lambert Group), 138 B.R. 687, 702 (Bankr. S.D.N.Y. 1992).

81. Bd. of Trade v. Johnson, 264 U.S. 1, 12 (1924).

82. *In re* Draughon Training Inst., 119 B.R. 921, 926 (Bankr. W.D. La. 1990).

83. *See supra* note 58 and accompanying text.

84. *See, e.g.*, Howard, *supra* note 70, at 288 ("[C]onstitutional analysis does not differ depending upon whether the rights involved are described as property rights or contract rights . . . ."); Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857, 880 (1982) ("The Bankruptcy Code provides no explanation for th[e] distinction between lenders and other contract holders . . . ."); Kreynin, *supra* note 41, at 1109 ("There are no significant functional differences between the property and contract interests of creditors.").

mandatory rules and is hostile to attempts to change the results that would be reached in bankruptcy.[85] As opposed to commercial law, in which parties can generally override defaults, parties must use the federal bankruptcy system and cannot contract around it. Stuck with the bankruptcy system, contracting parties also cannot modify by agreement most of its rules.[86] Further, the flexibility of courts in drawing the distinction between contract and property can easily counteract any attempts by contracting parties to control their bankruptcy outcome. For example, one practitioner suggests in the context of special shopping center easements that the covenants, conditions, and restrictions (CC&R) document could be treated as "a collection of individual covenants with each set of dependent covenants, restrictions and easements being treated separately. Those that are essentially property rights would be denied Section 365 treatment. The others might be subject to Section 365."[87] Later in this Note, I will examine other instances where judicial decisions on whether to treat a right primarily as contract or primarily as property led to significant differences in the outcome. Moreover, parties may not consider the potential bankruptcy treatment of their transactions before they enter into them.[88]

My argument is that property-contract parity matters, in part because it can rectify distortions in prebankruptcy contracting among parties. Bankruptcy has motivating principles other than increasing the efficiency of the nonbankruptcy economy, however;[89] it also has an element of debtor protection and empowerment. It provides a breather from creditor pressure, helping keep firms alive; it can give a fresh start, with freedom from debt; and it can force creditors to renegotiate contracts in the shadow of a bankruptcy filing.[90] In the context of this Note, however, where I am only dealing with business bankruptcy and describing a more efficient normative

85. *See* Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1808 (1998).

86. *Id*. at 1808-09.

87. Garfinkel, *supra* note 58, at 428.

88. *But see infra* notes 150-151 and accompanying text.

89. There are two general schools of thought in bankruptcy scholarship. The "proceduralists" care mostly about bankruptcy's effect on the nonbankruptcy world. Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573, 578 (1998). "Traditionalists," on the other hand, do not care much about these ex ante effects and worry instead about bankruptcy's effects on a debtor firm's workers and community. *Id*. at 582-83, 589. This Note is in the proceduralist camp and does not significantly address a traditionalist critique, which would likely deny any currency to most of my argument, *cf. id*. at 574-75 (arguing that "the starting places [of the two groups] are far apart and the chance that new information will do much to bring them closer together is remote" because their differences stem "from radically different views of the underlying normative bases of the role of bankruptcy law"). Because my argument is that bankruptcy should mirror nonbankruptcy entitlements more, not less, and because the traditionalist argument is generally the opposite, *cf. id*. at 578, I feel there would be little value in arguing from first principles.

90. *See* JACKSON, *supra* note 3, at 4.

foundation for bankruptcy law, these other goals of the bankruptcy system do not apply with much force.[91] As Jackson wrote, "When . . . dealing with firms, the [underlying question of bankruptcy] is how to convert ownership of the assets from the debtor to its creditors, not how to leave assets with the debtor."[92]

B. *Justifications for the Property-Contract Distinction*

It is a commonplace that bankruptcy impairs contracts; arguably this is the whole purpose of bankruptcy law.[93] This difference in treatment is typically supposed to have derived from the Constitution and, in particular, the Contracts Clause:[94] Because the Contracts Clause prohibits only the states from impairing contracts,[95] and because Congress has the affirmative power to pass bankruptcy laws,[96] Congress has the unique constitutional authority to impair contracts.[97] One commentator suggests that the early bankruptcy cases decided by the Supreme Court did not "rely on any simplistic notion of the supposed distinction between contractual and property rights," but that "because such impairments are inevitable in the bankruptcy system, they necessarily must be authorized by the bankruptcy clause."[98]

Just because contracts can be impaired, however, does not mean that the property in contracts should not be treated like property. James Rogers

91. *See id*. at 4-5. Although we might be especially sympathetic to these aims when we are thinking about small, unique, or vulnerable businesses, I am here concerned with the overall policy justifications of bankruptcy law. I follow Jackson and others in positing that the place to make policy changes in favor of these businesses is in nonbankruptcy law, not in bankruptcy law. *Cf*. *id*. at 1-5.

92. *Id*. at 5.

93. One congressman, speaking about what was to become the Bankruptcy Act of 1800, said that "'no system of bankruptcy could be formed without affecting in some degree the contracts in existence at the time.'" CHARLES WARREN, BANKRUPTCY IN UNITED STATES HISTORY 14 (photo. reprint 1994) (1935) (quoting William Kraik).

94. Kuehner v. Irving Trust Co., 299 U.S. 445, 451-52 (1937).

95. U.S. CONST. art I, § 10, cl. 1 ("No *State* shall . . . [pass any] Law impairing the Obligation of Contracts . . . ." (emphasis added)).

96. *Id*. art. I, § 8, cl. 4.

97. Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 589 (1935) ("Under the bankruptcy power Congress may discharge the debtor's personal obligation, because, unlike the States, it is not prohibited from impairing the obligation of contracts."). In one case, while discussing the context of Congress's commerce power, the Supreme Court examined Congress's ability to impair contracts (and made reference to the agreement-obligation dichotomy): "Contracts *may create rights of property*, but when contracts deal with a subject matter which lies within the control of the Congress, they have a congenital infirmity. Parties cannot remove their transactions from the reach of dominant constitutional power by making contracts about them." Norman v. Balt. & Ohio R.R. Co., 294 U.S. 240, 307-08 (1935) (emphasis added).

98. James Steven Rogers, *The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause*, 96 HARV. L. REV. 973, 998 (1983).

notes that "the Court has never suggested that, merely because the fifth amendment refers to 'property' and the contracts clause by its terms applies only to the states, there is no basis for constitutional challenges to federal legislation impairing contractual rights."[99] One bankruptcy court recognized that "there is no constitutional reason for treating contracts (which are merely another form of property) and liens (which are merely another form of contract) differently in bankruptcy."[100] In other words, simply because Congress can treat contracts and property differently does not mean that Congress should and certainly does not mean that it must.

The Supreme Court, however, stated in *Security Industrial Bank* that a secured creditor's contractual rights "may be quite different in legal contemplation" from that creditor's property rights.[101] The real issue in that case was that the Bankruptcy Reform Act of 1978 had provided exemptions for certain kinds of security interests; the law applied to secured creditors who had taken these security interests before the passage of the Act, and some of these creditors claimed that this law worked a taking of their property.[102] The United States, as appellant, argued that bankruptcy principles did not support different treatment for property and contract creditors,[103] but it was ultimately defeated. The Court held that the law could not harm these creditors but, in dicta, disagreed with the government's argument. In doing so, it relied on questionable authority.[104] *Security Industrial Bank* remains unsatisfactory, both for its failure to follow prior cases and for its reliance on *Radford*.[105]

99. *Id*. at 990.

100. Pillow v. Avco Fin. Servs. (*In re* Pillow), 8 B.R. 404, 419 (Bankr. D. Utah 1981). "Does a lien on a second-hand portable television worth $200 . . . enjoy more constitutional protection than an unsecured claim for $11,000,000? Should the lien survive while the contract is wiped out in bankruptcy?" *Id*.

101. United States v. Sec. Indus. Bank, 459 U.S. 70, 75 (1982).

102. *Id*. at 71-73.

103. Appellant's Brief at 31, *Sec. Indus. Bank* (No. 81-184).

104. The Supreme Court's 1935 *Radford* opinion contains the original phrasing of *Security Industrial Bank*'s dicta. Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 588 (1935) ("It is true that the position of a secured creditor, who has rights in specific property, differs fundamentally from that of an unsecured creditor, who has none . . . ."). This statement in *Radford* was not supported by any authority, and subsequent cases (until *Security Industrial Bank*) did much to diminish its power. *See In re Pillow*, 8 B.R. at 414-15, 419-21, 421 n.25; *see also* Rogers, *supra* note 98, at 1018 ("*Radford*'s analytic assumptions should . . . be regarded as little more than a sport."). While Congress certainly has the power to treat the two types of rights differently, and while it has exercised that power to some extent, my argument is that the dicta in *Radford* and *Security Industrial Bank* are unnecessary and even detrimental in the bankruptcy setting.

105. *See* Rogers, *supra* note 98, at 1020, 1014-21 (devoting eight pages to the flaws in the *Security Industrial Bank* opinion and stating that "there is no sound basis for contending that the interest of unsecured creditors in the debtor's estate as a whole is any less of a property interest than is the interest of secured creditors in their specific collateral"); Kreynin, *supra* note 41, at 1109-10.

The case, furthermore, does not preclude my thesis here. The Court's holding was that bankruptcy laws would not "be construed to eliminate property rights [retrospectively] in the absence of an explicit command from Congress,"[106] but this does not in any way impede the application of property-contract parity. Contractual rights can be impaired in bankruptcy not because they are somehow inferior to property rights but because they include an implied provision that they may be impaired by the bankruptcy laws. Also, property is not sacrosanct, because Congress could eliminate property rights in bankruptcy with an "explicit command," and nothing prevents contracts from being treated with as much deference as property.[107]

Furthermore, property and contract have been treated quite similarly in the past. A writer supporting bankruptcy legislation in 1819 suggested that, under a bankruptcy law, the assets of an insolvent would be "subject to the debts of all his creditors, without any distinction, ... [because the] law places all private contracts on the same foundation."[108] Bankruptcy Judge Mabey argued that there is no basis for thinking Congress can impair contracts but not property.[109] Searching legal history back to 1542, he discovered a foundational bankruptcy principle of creditor equality,[110] concluding that liens, "like other contract and property interests, are not inviolable, but subject to congressional power to regulate bankruptcies."[111]

106. *Sec. Indus. Bank*, 459 U.S. at 81.

107. Some scholars complain that calls to give property rights less deference are not realistic, *see, e.g.*, Julia Patterson Forrester, *Bankruptcy Takings*, 51 FLA. L. REV. 851, 877 (1999), but the claim I am making is that contract should be treated with more deference, not that property should be treated with less.

108. CIVIS, REMARKS ON THE BANKRUPT LAW: TO WHICH ARE ADDED THE PROPOSED AMENDMENTS OF HOPKINSON AND WEBSTER 46 (New York, Hart & Thomas 1819). The same writer, complaining about the property-contract differential in state insolvency laws, asked, "Are not goods a representation of money? What difference does it make whether A. lends B. $1000, or credits him with his goods, for which he has just paid the same amount?" *Id.* at 12.

109. *In re Pillow*, 8 B.R. at 420. He also called the property-contract distinction "probably indefensible under the Fifth Amendment." *Id.* at 421 n.25.

110. *Id.* at 421.

111. *Id.* at 424; *see also* WARREN, *supra* note 93, at 157 ("[I]t is difficult to see why the contract of a secured creditor may not be impaired as well as the contract of an unsecured creditor. It would appear that a statute which prevents A from suing on B's unsecured note takes away property rights belonging to A . . . . [like] a statute which takes away property held by A under B's secured note. In both cases, it would seem that the statute [affects] a property right of A." (endnote omitted)).

III. PROPERTY, CONTRACT, AND BANKRUPTCY: WHAT SHOULD BE DONE?

A. *Property-Contract Parity in Bankruptcy*

Bankruptcy's differential treatment of contract and property is problematic. It has resulted in varying, rather than "uniform,"[112] application of the bankruptcy laws. Although contractual rights are property, bankruptcy often does not treat them as such, which accords with bankruptcy's occasional propensity to eschew consistency and coherence. "Bankruptcy law has, for too long, been molded and interpreted without any systematic questioning or understanding of its normative role in a larger legal, economic, and social world."[113] The Bankruptcy Code also does not justify its inequitable treatment of different creditors.[114] It is my hope that the redefinition of contract can lend some consistency to the creation and application of bankruptcy law.

First, let me make clear what I am not doing: I am not advocating that contracts be immune from impairment under the bankruptcy system. Complete protection of contracts as property would preclude a fully functioning system of bankruptcy. My proposal should not disrupt the bankruptcy system, because, even as property, contracts are not immune to many of the bankruptcy-related types of impairment.[115]

Contracts are made "subject to constitutional power in the Congress to legislate on the subject of bankruptcies."[116] This power is an implied term written into contracts between creditors and debtors, and one which

112. U.S. CONST art. I, § 8, cl. 4 (providing that Congress has the power to "establish . . . uniform Laws on the subject of Bankruptcies throughout the United States").

113. Jackson, *supra* note 84, at 907 ("At other places the Bankruptcy Code itself seems to deviate, without explanation, from a model that seems to illuminate and justify much of the bankruptcy process.").

114. *See, e.g.*, *id.* at 880.

115. In *Ogden v. Saunders*, one Justice in the majority held that a law in effect when a contract is made "forms a part of that contract, and of its obligation," so it cannot "impair that obligation." 25 U.S. (12 Wheat.) 213, 260 (1827) (opinion of Washington, J.). In 1870, the Supreme Court reaffirmed this position, stating that "contracts must be understood as made in reference to the possible exercise of the rightful authority of the government." Legal Tender Cases, 79 U.S. (12 Wall.) 457, 551 (1870). Discussing the Bankruptcy Acts of 1867 and 1898, the Court reiterated that "all contracts [a]re made with reference to existing laws." Hanover Nat'l Bank v. Moyses, 186 U.S. 181, 189 (1902). By 1935, the Court called it an "established principle" that contracts have a "congenital infirmity" when they deal with a matter in the control of Congress. Norman v. Balt. & Ohio R.R. Co., 294 U.S. 240, 307-08 (1935) (dealing with the Commerce Clause, not the Bankruptcy Clause). Because property is held at the mercy of the law, and the current and future bankruptcy laws are incorporated as limitations into these contracts, contractual property is created with built-in limits. *But cf.* Sturges v. Crowninshield, 17 U.S. (4 Wheat.) 122, 206 (1819) (Marshall, C.J.) (stating that, with regard to state laws, the Constitutional Convention "appears to have intended to establish a great principle, that contracts should be inviolable").

116. Wright v. Union Cent. Life Ins. Co., 304 U.S. 502, 516 (1938).

includes both existing and future bankruptcy laws.[117] Because both the creditor and the debtor know that, in the event of bankruptcy, their contractual rights will be affected by current and future bankruptcy laws, the bankruptcy system's impairment of contractual obligations does not offend my thesis or definition of contract.

Acceptance of property-contract parity, therefore, will not be harmful in a larger sense. First, it will simply square bankruptcy with other areas of the law. Second, because property-contract parity recognizes the limited (by the terms of the contract) nature of contractual property, parties will have control over their treatment in bankruptcy. Contractual rights are property because they are held at the mercy of the law. If the law that would convert them into tangible property also provides that bankruptcy may alter them, the holder of those rights cannot be heard to complain.

Another example of how contracts are limited by their definition lies in the interdependent nature of contractual obligations.[118] One bankruptcy court, for example, held that moneys withheld under a contract are not property of the estate (counter to the general rule) when the debtor has breached the contract.[119] When the debtor breaches the contract, it loses its legal interest in the obligations that were owed to it, so those contractual obligations do not become property of the bankruptcy estate.[120]

Just as a contractual right can be limited by its legal definitions, so can other types of property in bankruptcy. A leading case for this proposition is *Board of Trade of Chicago v. Johnson*.[121] In *Board of Trade*, the bankrupt owned a membership on the Chicago Board of Trade (CBOT), but such memberships were only transferable upon full payment of loans to other members of the CBOT.[122] The Supreme Court held that, because the property was by definition subject to these restrictions, the loans must be paid before the trustee could "realize anything on the transfer of the [membership] for the general estate."[123] This property was not a chose in action or a contractual right,[124] but it was still subject to limitations based on its legal definition.

117. *See id*.; *see also* First Nat'l Bank of Chi. v. Prima Co. (*In re* Prima Co.), 88 F.2d 785, 788 (7th Cir. 1937) ("[A]ll contracts are made with the knowledge that existing bankruptcy laws may be amended."). *But see* Richard A. Epstein, *Toward a Revitalization of the Contract Clause*, 51 U. CHI. L. REV. 703, 727, 726-27 (1984) (suggesting that it violates the Contracts Clause to allow that "all private contracts are entered into subject to a 'master term'" and that notice of such term is not sufficient to mitigate the problem).

118. *See* Westbrook, *supra* note 64, at 247.

119. Halstead Contractors v. C & C Excavating (*In re* C & C Excavating), 288 B.R. 251, 257 (Bankr. N.D. Ala. 2002); *see id*. at 259-62 (mentioning cases).

120. *Id*. at 262.

121. 264 U.S. 1 (1924).

122. *Id*. at 14.

123. *Id*. at 15.

124. *Id*. at 12.

Why should bankruptcy treat contract more like property? The scope and nature of a debtor's interest in property are generally determined by applicable nonbankruptcy law.[125] Generally, that law is state law; the Supreme Court has held that property interests are "created and defined by state law" and should not be "analyzed differently simply because an interested party is involved in a bankruptcy proceeding" unless "some federal interest requires a different result."[126] This rule, the *Butner* rule, generally stands for the proposition that bankruptcy should not alter state property rules without a special bankruptcy policy for doing so.[127] Because state law, i.e., applicable nonbankruptcy law, treats contractual obligations as property, bankruptcy should do the same, unless a special bankruptcy policy suggests otherwise.[128] Thus, a proper reframing of the question that began this paragraph would be this: Why should bankruptcy *not* treat contract more like property?

In many instances, there does not seem to be a good answer to why bankruptcy should treat contract and property so differently. Debtors should not be granted greater contractual rights within bankruptcy than they had outside of bankruptcy. While the nature of bankruptcy requires some unraveling of contracts to save the debtor from itself, this should be done according to the rules agreed on beforehand by the contracting parties. The nondebtor knew from the beginning that bankruptcy could undo the contract; this is an inherent limitation upon the contract, and the nondebtor cannot complain. There is no justification, however, for the debtor's receiving more rights under the contract than were available the moment before the bankruptcy filing.[129]

Following property-contract parity could help make bankruptcy law fairer and more internally consistent and could better protect potential debtors and creditors. The goal of improving the bankruptcy system is

125. Slater v. Town of Albion (*In re* Albion Disposal), 217 B.R. 394, 402 (W.D.N.Y. 1997); *see also* Butner v. United States, 440 U.S. 48, 56 (1979) ("[T]he federal bankruptcy court should take whatever steps are necessary to ensure that the [creditor] is afforded in federal bankruptcy court the same protection he would have under state law if no bankruptcy had ensued."); Valley Forge Plaza Assocs. v. Schwartz, 114 B.R. 60, 62 (E.D. Pa. 1990) ("A debtor in bankruptcy has no greater rights or powers under a contract than the debtor would have outside of bankruptcy.").

126. *Butner*, 440 U.S. at 55.

127. This proposition applies to constitutional definitions of property as well. Segal v. Rochelle, 382 U.S. 375, 379 (1966) (stating that property definitions under the Fifth Amendment "cannot decide hard cases under the Bankruptcy Act, whose own purposes must ultimately govern").

128. *See, e.g.*, *Bd. of Trade*, 264 U.S. at 10; First Nat'l Bank of Balt. v. Staake, 202 U.S. 141, 148 (1906); Pillow v. Avco Fin. Servs. (*In re* Pillow), 8 B.R. 404, 419 (Bankr. D. Utah 1981).

129. In the context of my argument, it is important that secured creditors have both property rights in their security interest and property rights in their contract with the debtor. Similarly, unsecured creditors have property rights in their contracts. It is my position that all these property rights should be treated equally. I do not, however, address or suggest any change in the rules of perfection or priority.

important because property and contractual rights are key to the smooth functioning of our economic enterprises.[130] The current mandatory contract rules in bankruptcy do not further ex post efficiency,[131] so the property-contract distinction is not actively creating positive effects. Also, parties who do not make business decisions with bankruptcy in mind often are hurt by bankruptcy's differential treatment of similar transactions.[132]

Several arguments against property-contract parity do exist. For example, Congress might be unwilling to treat unsecured creditors as having property rights for political reasons. Bankruptcy courts may wish to retain their flexibility and not be limited to following one particular policy in deciding these cases. It is also possible that adopting property-contract parity could distort nonbankruptcy incentives, make bankruptcy cases more complex, or be difficult to apply in a great number of proceedings. While the political realities are beyond the arguments of this Note, the fact that (as will be seen) some courts have already come to the conclusions suggested by property-contract parity suggests that property-contract parity should not adversely affect the bankruptcy system's functioning. As for distorting nonbankruptcy incentives, while advantages may shift somewhat, greater consistency and predictability should redound to the benefit of all parties.

It is not that treating contracts as property will by itself transform bankruptcy law, but legislative and judicial recognition of property-contract parity could result in more principled decisionmaking and more predictable outcomes. As shown in Section B, bankruptcy courts differ widely on the application of fundamental bankruptcy principles. I argue that many of these divergences might be rectified if bankruptcy law rested on a more solid policy foundation. Property-contract parity is one proposal for a normative justification that could rectify the problems I identify in Section B, leading to a more consistent, more efficient bankruptcy system and improving both ex ante and ex post efficiency. While other solutions to these problems may exist, property-contract parity hews closest to nonbankruptcy law and to the fundamental goals of bankruptcy law. For example, § 365(h) and § 365(n) protect nondebtor parties' property rights (when the nondebtor party is a tenant or a licensee of intellectual property,

130. *See* James W. Bowers, *Rehabilitation, Redistribution or Dissipation: The Evidence for Choosing Among Bankruptcy Hypotheses*, 72 WASH. U. L.Q. 955, 977 (1994); *cf.* Payne v. Tennessee, 501 U.S. 808, 828 (1991) ("Considerations in favor of *stare decisis* are at their acme in cases involving property and contract rights, where reliance interests are involved . . . .").

131. Schwartz, *supra* note 85, at 1843. Although the ability of parties to bargain around these rules suggests that the problem of the property-contract distinction may not be serious, two issues still remain: Even in a Coasean transaction, the initial placement of the entitlement can lead to disparities in wealth, and the uncertainty created by judicial decisions on whether something is treated as property or contract will impair bargaining.

132. *Cf.* Howard, *supra* note 70, at 253 (discussing the choice between leasing equipment and buying it on credit).

respectively).[133] These provisions grant property-contract-parity treatment to both parties, thereby matching the treatment both parties would receive under nonbankruptcy law. I would argue that the step of adding § 365(n), although too small and without a true overarching policy justification, has brought increased efficiency and certainty to intellectual property licensing.[134]

The next Section examines several areas where the current property-contract distinction leads to troubling differences and demonstrates how property-contract parity would improve bankruptcy law by respecting nonbankruptcy law, eliminating inequities, and minimizing judicial uncertainty.

B. *The Current Approach: Problems and Solutions*

1. *Landlords Under § 502(b)*

One example of the current property-contract distinction is evidenced in § 502(b)(6) of the Bankruptcy Code. The Code caps claims by lessors for lease termination at the greater of one year's damages or fifteen percent of the total lease, not to exceed three years.[135] Thus, if a tenant goes bankrupt, its landlord's claim is capped, unlike the claims of other creditors. This inequitable treatment stems from many misconceptions, the most important of which is the seeming failure to respect property-contract parity.

The roots of § 502(b)(6) reach to the Bankruptcy Act of 1898, as amended in 1934, when Congress changed section 77B of the Act to limit rent claims to "an amount not to exceed the rent . . . reserved by said lease for the [next] three years."[136] The reason for these claim limitations was to aid debtor rehabilitation.[137] Congress felt that rent claims were too large and that landlords, because they would retain their rental property, were different than other creditors.[138] Section 502 was "derived from" section 77B to limit the "damages allowable to a landlord of the debtor."[139] The intent was to "compensate the landlord for his loss while not permitting a

133. *See infra* text accompanying notes 207-210.

134. *Cf.* S. REP. NO. 100-505, at 3-4 (1988), *reprinted in* 1988 U.S.C.C.A.N. 3200, 3202-03 (discussing Congress's concerns, before the adoption of § 365(n), about the viability of intellectual property licensing).

135. 11 U.S.C. § 502(b)(6)(A) (2000).

136. Act of June 7, 1934, ch. 424, § 77B(b), 48 Stat. 911, 915, 913-15 (current version at 11 U.S.C. § 502), *quoted in* City Bank Farmers Trust Co. v. Irving Trust Co., 299 U.S. 433, 439 n.4 (1937).

137. Oldden v. Tonto Realty Corp., 143 F.2d 916, 920 (2d Cir. 1944).

138. *Id.*; *see also* Kuehner v. Irving Trust Co., 299 U.S. 445, 455 (1937) (describing the "distinction" between landlords and other creditors).

139. S. REP. NO. 95-989, at 63 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5849.

claim so large (based on a long-term lease) as to prevent other general unsecured creditors from recovering . . . from the estate."[140] Congress identified two historical justifications for this limitation: Lease breach damages were "considered contingent and difficult to prove," and claim limitation was "considered equitable" because the landlord "retains all risk and benefits as to the value of the real estate" even after termination.[141]

Congress's rationales for § 502(b)(6) are not without vehement critics,[142] and for good reason. First, the worry about overly large claims is especially hard to justify: "If the nominal claim is large, it is only because the damages . . . are large."[143] That is a better reason to favor landlords than to harm them. Second, as others have noted, the concern about the contingency and speculative nature of contracts is also unconvincing. "Uncertainty about the future . . . does not necessarily favor a landlord."[144] Other long-term contracts are not subject to the same treatment.[145] Contingent claims are not seen as problematic in other sections of the Code;[146] there should be no reason that bankruptcy courts can value a prejudgment tort claim[147] but not a lease. Third, Congress's satisfaction that the landlord enjoys the return of her rental property is correct but slightly irrelevant to the point. The landlord always had rights in her property, so the Code grants nothing extra. What the landlord did have, and lost under the Code, was the property in her contractual obligations under the lease. The real problem is that landlords, their rights protected outside of bankruptcy, lose their rights inside bankruptcy. While the bankruptcy procedure changes the nature of many rights, there seems no particular reason to choose landlords for this special diminishment of rights.[148]

Commentators have noted that this section lacks a solid policy justification.[149] It also perverts transactions in the nonbankruptcy world. Tenants know the system and take advantage of their generous treatment,

140. *Id.*

141. *Id.* at 64, *reprinted in* 1978 U.S.C.C.A.N. 5787, 5850.

142. *See, e.g.*, JACKSON, *supra* note 3, at 56 (calling the rationales "unsatisfying on their own terms" and having "nothing to do with the role of bankruptcy as a collective debt-collection device").

143. *Id.* at 57.

144. *Id.*

145. *Id.* at 57 n.77.

146. 11 U.S.C. § 101(5) (2000) (providing that a "claim" is any "right to payment, whether or not such right is . . . fixed [or] contingent").

147. *See, e.g.*, Bittner v. Borne Chem. Co., 691 F.2d 134 (3d Cir. 1982).

148. *Cf.* Valley Forge Plaza Assocs. v. Schwartz, 114 B.R. 60, 62 (E.D. Pa. 1990); JACKSON, *supra* note 3, at 57.

149. *See* JACKSON, *supra* note 3, at 56; James W. Bowers, *Whither What Hits the Fan?: Murphy's Law, Bankruptcy Theory, and the Elementary Economics of Loss Distribution*, 26 GA. L. REV. 27, 32 & n.15 (1991) (suggesting that Congress used a "'what-else-when-you-don't-know-anything' justification" when enacting § 502(b)(6)).

ensuring that landlords cannot secure long-term commercial leases.[150] While landlords negotiate with this rule in mind as well,[151] they nevertheless lose their property rights in bankruptcy and cannot contract around the rule.

Leases have elements of property and contract,[152] but Congress treats leases as contract here.[153] This treatment appears reasonable because commercial leases are virtually all contractual;[154] in doing so, however, Congress forgets about the property that exists in contracts. Landlords' contractual rights are property, and capping those rights under § 502(b)(6) disregards that property.[155]

Under property-contract parity, the Code should allow landlords to claim the full extent of their contractual damages. Of course, landlords should not get windfalls; as under other contracts, landlords are under a duty to mitigate and cannot collect double rent.[156] Thus, a landlord should be able to hold a valid claim for the full contractual (after mitigation) damages from its broken lease.[157]

150. *See* Marcus Cole, *Limiting Liability Through Bankruptcy*, 70 U. CIN. L. REV. 1245, 1286, 1285-86 (2002) ("[R]etailers frequently visit the question as to which of their locations are unprofitable, and . . . resort to chapter 11 of the bankruptcy code to shed the leases to those unprofitable sites[,] . . . . without regard to the solvency of the firm overall.").

151. *Id*. at 1286 (noting that the length of leases and the amount of security deposits often track the allowed one-year damages claim).

152. *See, e.g.*, Javins v. First Nat'l Realty Corp., 428 F.2d 1071, 1075 (D.C. Cir. 1970); Mary Ann Glendon, *The Transformation of American Landlord-Tenant Law*, 23 B.C. L. REV. 503, 503 (1982); Merrill & Smith, *supra* note 9, at 820.

153. Section 502(b)(6) treats the breach of the lease as a contract claim. *See also* 11 U.S.C. § 365(h) (2000) (dealing with leases); Control Data Corp. v. Zelman (*In re* Minges), 602 F.2d 38, 41 (2d Cir. 1979) ("[L]eases are generally treated as executory contracts in the bankruptcy context . . . ."). *But see Control Data*, 602 F.2d at 41 (noting that leases do "raise some unique considerations" because the "conveyance aspect of a lease may not ordinarily be unilaterally disturbed by a debtor landlord").

154. *See, e.g.*, Park W. Mgmt. Corp. v. Mitchell, 391 N.E.2d 1288, 1292 (N.Y. 1979); Glendon, *supra* note 152, at 559.

155. *Cf.* JACKSON, *supra* note 3, at 110 (arguing that leases should be treated in bankruptcy the same way as under nonbankruptcy law). The Supreme Court has disregarded this existence of property in lease contracts as well. *See* Kuehner v. Irving Trust Co., 299 U.S. 445, 455 (1937) (stating that a difference between landlords and other creditors is that the former "have lost merely a bargain for the use of real estate, whereas [other] creditors . . . recover in specie none of the property or money which passed from them to the debtor").

156. *See* THOMAS J. MICELI ET AL., THE DUTY TO MITIGATE DAMAGES IN LEASES: OUT WITH THE OLD RULE AND IN WITH THE NEW 2 (Ctr. for Real Estate, Working Paper No. 307, 2001), *available at* http://ssrn.com/abstract=304963; *cf.* ROGER A. CUNNINGHAM ET AL., THE LAW OF PROPERTY § 6.82, at 408 (2d ed. 1993); Robert H. Kelley, *Any Reports of the Death of the Property Law Paradigm for Leases Have Been Greatly Exaggerated*, 41 WAYNE L. REV. 1563, 1585-87 (1995). The ability to mitigate seems related to the concern that the landlord retains the property and thus does not truly "lose" when the lease is terminated. However, parties to other contracts also have duties to mitigate, but their claims are not limited by § 502.

157. *Cf.* City Bank Farmers Trust Co. v. Irving Trust Co., 299 U.S. 433, 443 (1937) (stating that, under the old section 77B, the landlord's claim was "the difference between the rental value of the remainder of the term and the rent reserved"); Irving Trust Co. v. A.W. Perry, Inc., 293 U.S. 307, 311 (1934) (finding "a reasonable formula for ascertaining the damages of the landlord"

This solution, while an improvement, is still problematic when the market value of the leased premises has dropped. In that case, mitigation will not yield the same rental payments, and landlords will face an exogenous cap on their damages. The property-contract-parity approach again suggests an answer: The contractual right to that difference is property[158] and should be respected by the Code. Landlords should receive as a claim any difference between the contractual rent and the market value of their property.[159]

2. *Automatic Stay*

The current property-contract distinction causes problems in the context of the automatic stay. The automatic stay protects the debtor from creditors trying to get their money or property after the debtor has filed for bankruptcy. Here, the problem is an incomplete acceptance of parity, which leads to disparate treatment of debtors and creditors. As will be seen, complete acceptance of property-contract parity should resolve this inequity and lead to more consistent, coherent results.

In *Cahokia Downs*, the bankruptcy court held that an insurance company could not cancel its insurance policy (in accordance with a cancellation provision in the contract) after the insured entered Chapter 11.[160] The debtor's insurance company had canceled its fire policy with only a month left to run on the contract.[161] While the insurer seemed to have canceled primarily because of the bankruptcy filing,[162] which is not typically allowed, the court reached its result through problematic means. It

was "the difference between the present fair value of the remaining rent due under the lease and the present fair rental value of the premises for the balance of the term").

158. "'Premium' rent . . . is the amount by which the fair rental value of the premises at the time the lease was executed exceeds the fair rental value over the remaining term of the lease." Midler Court Realty v. Comm'r, 521 F.2d 767, 769 (3d Cir. 1975). A "premium lease" is a lease with such a premium rent. WILLIAM A. KLEIN ET AL., FEDERAL INCOME TAXATION 784 (12th ed. 2000).

Premium rent has generally been recognized as contractual property, *see, e.g.*, World Publ'g Co. v. Comm'r, 299 F.2d 614, 620 (8th Cir. 1962); Comm'r v. Moore, 207 F.2d 265, 277 (9th Cir. 1953); Norton L. Steuben, *The Income Tax Treatment of Interests Acquired from a Ground Lessor*, 23 FLA. ST. U. L. REV. 863, 891 (1996), although there has been some dissent, *see, e.g.*, Schubert v. Comm'r, 286 F.2d 573 (4th Cir. 1961); Moore v. Comm'r, 15 T.C. 906 (1950), *rev'd*, 207 F.2d 265 (9th Cir. 1953).

159. This should hold true even if the debtor no longer rents the property. Although the debtor is no longer receiving the benefit of the bargain in being able to occupy the property, the difference between contract rent and market rent is contractual property that is due the landlord regardless, as contractual damages.

160. Holland Am. Ins. Co. v. Sportservice (*In re* Cahokia Downs), 5 B.R. 529, 531 (Bankr. S.D. Ill. 1980).

161. *Id.* at 530-32.

162. *Id.* at 530.

reasoned that the insurance contract was property of the debtor's estate;[163] any attempt to cancel the contract would violate § 362 of the Bankruptcy Code, which stays any "act to obtain possession of property of the estate."[164] This analysis, which thwarts property-contract parity, has been followed by some courts[165] and rejected by others.[166]

Courts evaluating claims involving government licenses have also used this § 362(a)(3) analysis. For example, in *Draughon Training*, where the Texas Education Association revoked a school's license in part for its failure to comply with tuition reimbursement rules, the court held the license to be the school's property and its denial a violation of § 362(a)(3).[167] As in the insurance policy cases, some courts have stayed state license restrictions under § 362(a)(3), and some have not.[168]

These kinds of profound disagreements about basic elements of bankruptcy are symptoms of the misunderstood interaction between property and contract. A proper understanding of property-contract parity would allow courts to decide these cases consistently and parties to better predict the treatment of their rights in bankruptcy.

In the insurance policy context, courts do see the contract as one of the bankruptcy estate's assets and, therefore, as property.[169] In the license cases, the courts also class the rights under license agreements as property.[170] So far, so good. The problem arises when some courts then find that cancellation of a contract or denial of a license is an act to "obtain possession of" or "control over" property of the estate and thus violative of § 362(a)(3).[171]

While these holdings may pervert the purposes of the automatic stay,[172] my concern is primarily with the misapplication of the concepts of property and contract. First, applying the stay to private contracts in this way is especially detrimental to nondebtor parties; ipso facto clauses are

163. *Id*. at 531.

164. 11 U.S.C. § 362(a)(3) (2000).

165. James O. Johnston, Jr., Note, *The Inequitable Machinations of Section 362(a)(3): Rethinking Bankruptcy's Automatic Stay over Intangible Property Rights*, 66 S. CAL. L. REV. 659, 682 n.134 (1992) (listing cases).

166. *Id*. at 685 nn.146 & 150-51 (listing cases).

167. *In re* Draughon Training Inst., 119 B.R. 921, 922-23, 926 (Bankr. W.D. La. 1990).

168. Johnston, *supra* note 165, at 692-93.

169. *See, e.g.*, Holland Am. Ins. Co. v. Sportservice (*In re* Cahokia Downs), 5 B.R. 529, 531 (Bankr. S.D. Ill. 1980).

170. *See, e.g.*, *In re Draughon Training*, 119 B.R. at 926; *id*. (citing cases); R.S. Pinellas Motel P'ship v. Ramada Inns (*In re* R.S. Pinella Motel P'ship), 2 B.R. 113, 118 (Bankr. M.D. Fla. 1979).

171. *In re Draughon Training*, 119 B.R. at 926; *In re Cahokia Downs*, 5 B.R. at 531.

172. *See* Johnston, *supra* note 165, at 679 (arguing that courts following *Cahokia Downs* and *Draughon Training* "betray the purpose of the automatic stay").

disregarded,[173] but this analysis also impairs termination provisions not based on financial situation and takes away nondebtors' contractual rights. Thus, under this automatic stay jurisprudence a nondebtor loses twice: It loses its valid termination rights as well as (typically) its right to full performance by the insolvent party. The debtor, on the other hand, gets more rights within bankruptcy, because the nondebtor loses its power to cancel the contract. A debtor in bankruptcy, however, should not be granted "greater rights or powers under a contract than the debtor would have outside of bankruptcy."[174] Courts should not so drastically reshape the risk allocation chosen by the parties, because doing so places all contracting parties in a state of uncertainty.[175]

The courts following *Cahokia Downs* and *Draughon Training* recognize contractual rights as property, but they do not recognize the solvent party's property rights in termination and do not consider the inherent definitional limitation of contractual property. The insolvent party certainly has property in the contractual obligations owed it, but the solvent party also has property under the contract. A court deciding cases under nonbankruptcy law would grant the solvent party the right to terminate its contract, but in these bankruptcy courts the solvent party loses that property.

The *Draughon Training* court realized that license transfer restrictions did not preclude a determination that the license was property.[176] Such restrictions and conditions do, however, limit the scope of the contractual property. Nonbankruptcy law defines the scope and extent of property rights, but bankruptcy law does not and should not change them without good reason.[177]

This contractual property comes into the estate with limitations—a termination provision or a license restriction—and should be treated accordingly. It is inequitable for the bankruptcy courts to disregard these limitations solely for the benefit of the debtor and to diminish rights expected by a nondebtor contracting with that debtor. The courts should grant nondebtors the termination rights and license restrictions bargained

173. 11 U.S.C. §§ 363(*l*), 365(e)(1)(A), 541(c)(1)(B) (2000). Ipso facto clauses allow contract termination for financial reasons like insolvency or bankruptcy.

174. Valley Forge Plaza Assocs. v. Schwartz, 114 B.R. 60, 62 (E.D. Pa. 1990).

175. This uncertain situation could put solvent parties in a precarious predicament because acting "in accord with [their] view of the dispute rather than that of the debtor-in-possession . . . would risk a determination by a bankruptcy court that [they] had 'exercised control' over intangible rights (property) of the estate." United States v. Inslaw, Inc., 932 F.2d 1467, 1472, 1472-73 (D.C. Cir. 1991).

176. *In re Draughon Training*, 119 B.R. at 926.

177. In the context of insurance policies, see DOUGLAS G. BAIRD & THOMAS H. JACKSON, CASES, PROBLEMS, AND MATERIALS ON BANKRUPTCY 541 (2d ed. 1990) ("Canceling the policy does not 'remove' property *from* the estate; it is part of what *defines* property *of* the estate.").

for by the parties and should not hold the exercise of these rights to be violations of the automatic stay. Full acceptance of property-contract parity, with its emphasis on this inherent property limitation, would adhere better to underlying bankruptcy policy, lead to more consistent decisions, and protect party expectations.

3. *Executory Contracts*

Executory contracts are dealt with primarily in § 365 of the Code, "a long, confusing section, full of detail, subtleties, and gaps."[178] The topic is complex, and I only deal with a very limited portion of it.

The major achievement in the field of executory contracts was Vern Countryman's 1973 definition of an executory contract as one "under which the obligation of both the bankrupt and the other party . . . are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other."[179] Despite this, the law of executory contracts remains a mess.[180] One bankruptcy court called the standard analysis of executory contracts "useless," stating, "[W]e believe that we could, using existing 'executoriness' precedent, plausibly justify any number of results, from affording either party the complete relief it seeks, to deciding the case as we actually do."[181] Commentators criticize the Code as well as its judicial interpretation. Some feel that its disregard of parties' nonbankruptcy rights is a serious flaw, especially when it allows rejection of contracts.[182] Others note the inefficiency caused by the mandatory rule of § 365[183] and the ineffectiveness of § 365 in deterring debtors from filing for bankruptcy.[184]

From the perspective of my argument, the troublesome issue in executory contracts is not that property and contracts are treated so

178. BRIAN A. BLUM, BANKRUPTCY AND DEBTOR/CREDITOR: EXAMPLES AND EXPLANATIONS § 18.1, at 353 (2d ed. 1999).

179. Vern Countryman, *Executory Contracts in Bankruptcy* (pt. 1), 57 MINN. L. REV. 439, 460 (1973).

180. One executory contract scholar argues that in no portion of the Bankruptcy Code "has the law become more psychedelic than in the one titled 'executory contracts.'" Westbrook, *supra* note 64, at 228. Courts "voice confusion and frustration over the treatment of contracts in bankruptcy," and critics "express growing concern about decisions that are deeply disruptive of commercial expectations, concerns awkwardly and inadequately addressed by recent congressional patchwork." *Id.* at 228-29. Indeed, some feel that the emphasis of a "definition of executory contract . . . . can lead to erroneous conclusions." Mitchell R. Julis, *Classifying Rights and Interests Under the Bankruptcy Code*, 55 AM. BANKR. L.J. 223, 253 (1981).

181. Cohen v. Drexel Burnham Lambert Group (*In re* Drexel Burnham Lambert Group), 138 B.R. 687, 696 (Bankr. S.D.N.Y. 1992).

182. JACKSON, *supra* note 3, at 109, 111, 119.

183. *Cf., e.g.*, Schwartz, *supra* note 85, at 1842-43 & n.93.

184. *Cf. id.* at 1846-47.

differently but that debtors and creditors are. The current property-contract distinction allows debtors to enjoy greater rights than they have outside of bankruptcy as compared to the other party to the contract.[185] The issue, simply stated, is this: The debtor's right to performance enters bankruptcy as property of the estate and is treated as property,[186] but the debtor's obligation to perform becomes the nondebtor party's claim, which is treated as contractual.[187] This "reduction of a property right to an ordinary claim"[188] disregards nondebtors' nonbankruptcy entitlements and expectations.

To demonstrate the problems caused by the current property-contract distinction, I examine a series of cases regarding covenants not to compete.[189] Courts are of two minds about the effect of rejection on covenants not to compete: Some hold the covenants to be rejected and thus unenforceable, while some hold them to be enforceable.[190]

The courts that have held covenants not to compete enforceable have done so because they found the contract nonexecutory[191] or because rejection of a contract does not affect the other party's property right to its

185. *But see* Johnston, *supra* note 165, at 677-78 (stating that "the power granted by section 365" does not expand "the debtor's contract rights" and that the "nondebtor remains free to exercise its preexisting right of termination"). Johnston, however, ignores § 365(e)(1)(A), which nullifies the nondebtor party's right to termination based on the debtor's financial condition.

186. The move into bankruptcy basically shifts a "property right" from the nondebtor party to the debtor party. Schwartz, *supra* note 85, at 1843.

There is some debate about whether an executory contract enters the estate before it is assumed, but the most logical conclusion is that the contract is property of the estate whether or not it is assumed. *Compare* Tonry v. Hebert (*In re* Tonry), 724 F.2d 467, 469 (5th Cir. 1984) ("[A]n executory contract comes into the estate only when assumed by the trustee."), *with* Computer Commc'ns v. Codex Corp. (*In re* Computer Commc'ns), 824 F.2d 725, 730 (9th Cir. 1987) (holding that an executory contract becomes property of the estate regardless of whether the trustee assumes it), *and* Ben-Dak Inv. Co. v. Vertich (*In re* Vertich), 5 B.R. 684, 686 (Bankr. D.S.D. 1980) (holding that rejection of a contract did not take it out of the bankruptcy estate).

187. *Cf.* Cohen v. Drexel Burnham Lambert Group (*In re* Drexel Burnham Lambert Group), 138 B.R. 687, 700 (Bankr. S.D.N.Y. 1992) ("A debtor's positions on both sides of its contracts follow it into bankruptcy, although by different routes.").

The nondebtor party is reduced to its contractual remedies: If the trustee assumes the contract, the nondebtor party gets performance; if the trustee rejects the contract, the nondebtor party gets damages (reduced by the bankruptcy recovery). The "rights and interests of the nondebtor party to the contract" are almost wholly dependent on how or whether § 365 applies to the contract. Julis, *supra* note 180, at 249.

188. DOUGLAS G. BAIRD ET AL., CASES, PROBLEMS, AND MATERIALS ON BANKRUPTCY 239 (rev. 3d ed. 2001).

189. Even though covenants not to compete are typically enforced by equitable remedies, they are valid claims under the Bankruptcy Code, 11 U.S.C. § 101(5) (2000), and are treated as capital assets for tax purposes, *see* B.T. Babbit, Inc. v. Comm'r, 32 B.T.A. 693, 696 (1935). Also, as contractual causes of action, they are valid choses in action.

190. Craig R. Tractenberg, *What the Franchise Lawyer Needs To Know About Bankruptcy*, 20 FRANCHISE L.J. 3, 6 (2000).

191. *See, e.g.*, *In re* Eyke, 246 B.R. 550, 556 (Bankr. W.D. Mich. 2000); *In re* Cutters, Inc., 104 B.R. 886, 890 (Bankr. M.D. Tenn. 1989); *In re* Noco, Inc., 76 B.R. 839, 843 (Bankr. N.D. Fla. 1987).

equitable remedy.[192] In *Don & Lin Trucking Co*., the debtor had rejected a contract with one partner and had signed a contract with that partner's competitor;[193] the court refused to allow a "debtor's rejection of [a] contract . . . [to] relieve it of the obligation not to compete."[194] The courts that have held unenforceable covenants not to compete emphasized the contractual nature of these covenants, holding them not severable from the rest of the contract.[195] In *Register*, the debtors signed a franchise agreement agreeing not to open a competing shop within a ten-mile radius; filed for bankruptcy; rejected the agreement; and opened a new, competing shop.[196] The court held that the covenant not to compete was terminated and limited the franchisor to money damages.[197] The two views differ because courts holding the covenants unenforceable did not view the covenants as property rights of the nondebtor party.[198]

One possible reason for this schizophrenic set of cases is that standard executoriness analysis fails to account for nonbankruptcy law.[199] Property-contract parity requires that the nondebtor party retain a property right in the covenant not to compete, even if the debtor's other obligations no longer exist.[200] Indeed, allowing debtors to rid themselves of covenants not to compete by rejecting executory contracts grants them rights they would not have under nonbankruptcy law.[201]

How can bankruptcy law solve these problems under property-contract parity? Contracts are conceptually difficult to deal with in the bankruptcy context because they consist of both rights and obligations, or assets and

192. *See, e.g.*, *In re* Don & Lin Trucking Co., 110 B.R. 562, 568 (Bankr. N.D. Ala. 1990); *In re* Carrere, 64 B.R. 156, 160 (Bankr. C.D. Cal. 1986); *see also In re Noco*, 76 B.R. at 844 (holding that the contract was not executory but noting that "even if such contract rejection were allowed, it is not legally conclusive that such rejection would rid the debtor of his obligation under the covenant not to compete"); Andrew, *Reply*, *supra* note 63, at 18 ("The enforceability of a covenant not to compete against a debtor does not turn on whether the contract containing the covenant is rejected, because rejection does not terminate the contract.").

193. *In re Don & Lin Trucking*, 110 B.R. at 563-64.

194. *Id*. at 568.

195. *See, e.g.*, Silk Plants, Etc. Franchise Sys. v. Register (*In re* Register), 95 B.R. 73, 74 (Bankr. M.D. Tenn. 1989); Burger King Corp. v. Rovine Corp. (*In re* Rovine Corp.), 6 B.R. 661, 666 (Bankr. W.D. Tenn. 1980).

Severability is the doctrine these courts typically used to reach the results they wished to reach, but executory contracts must be accepted or rejected in their entirety. *See In re Register*, 95 B.R. at 74; *In re Rovine*, 6 B.R. at 666. It is possible, however, for the "terms of the instrument [to] demonstrate that the parties intended to make two separate contracts." Byrd v. Gardinier, Inc. (*In re* Gardinier, Inc.), 831 F.2d 974, 976 (11th Cir. 1987); *see also In re Cutters*, 104 B.R. at 889. Mitchell Julis advises against viewing a contract as a "single entity," partly for this reason. *See* Julis, *supra* note 180, at 253.

196. *In re Register*, 95 B.R. at 73-74.

197. *Id*. at 75.

198. *See In re* Noco, Inc., 76 B.R. 839, 844 (Bankr. N.D. Fla. 1987).

199. *See, e.g.*, Westbrook, *supra* note 64, at 287.

200. *See* Julis, *supra* note 180, at 253.

201. *See* BAIRD ET AL., *supra* note 188, at 238.

liabilities.[202] Characterizing them as property, however, allows a *Board of Trade* analysis. Bankruptcy courts should set off the contract's rights and obligations against each other to arrive at a single value for that contractual property.[203] Doing so would protect the nonbankruptcy entitlements and expectations of both parties, while enhancing the predictability and uniformity of bankruptcy procedure.[204] The courts must also follow nonbankruptcy law to ensure that the debtor retains its interest in property, but as limited by the debtor's obligations and the creditor's rights.[205] Underlying property rights should not be affected by rejection of the contract.[206]

Congress actually has gone a short distance toward property-contract parity by enacting § 365(n) and § 365(h). Section 365(n), which "permits a licensee of intellectual property to retain its rights despite rejection of an executory contract,"[207] gives the nondebtor party back its property right (§ 365(h) does the same for nondebtor-lessees). Thus, if the trustee assumes the contract, the nondebtor party performs as normal. If, however, the trustee rejects the contract, the nondebtor party can choose either to take damages[208] (its typical contractual remedy) or to retain its rights under the contract[209] (a property right to the contract's benefits, good against the debtor and the debtor's creditors). These provisions recognize almost

202. Westbrook, *supra* note 64, at 247; *see also* JACKSON, *supra* note 3, at 106.

203. *See* JACKSON, *supra* note 3, at 107. So, there is "no reason to treat executory contracts any differently" than other assets. *Id.* Also, "[m]any assets are of value to a debtor and his general creditors but only net of some payment to someone else." *Id.* at 96.

204. While it might seem that this proposal would destroy the expectations of secured creditors and disrupt the bankruptcy system by putting all creditors into the same priority category, the consequences of property-contract parity are far less radical than they appear. First, for contracts that are not executory—contracts in which one side or the other has performed—the contract is already seen as an asset or liability of the debtor, and property-contract parity does not change this result. Netting the rights and obligations of executory contracts, as suggested by property-contract parity, arrives at a single asset or liability, which should not greatly change the result currently seen in bankruptcy (if an asset to the debtor, the debtor's estate increases; if a liability to the debtor, the creditor has a claim to that amount). The major change engendered by property-contract parity is that the solvent party retains its property rights created by the contract, such as covenants not to compete. As will be seen, Congress's addition of § 365(h) and § 365(n) were steps toward property-contract parity in specific situations.

205. *See* JACKSON, *supra* note 3, at 107; Countryman, *supra* note 179, at 456-57; Schuyler M. Moore, *Entertainment Bankruptcies: The Copyright Act Meets the Bankruptcy Code*, 48 BUS. LAW. 567, 588-89 (1993).

206. *See* Cohen v. Drexel Burnham Lambert Group (*In re* Drexel Burnham Lambert Group), 138 B.R. 687, 709 (Bankr. S.D.N.Y. 1992); *cf.* Andrew, *Contracts*, *supra* note 63, at 923 ("Thus, the estate's rights in the underlying asset—the copyright, trade secret, patent, equipment, or other property—still are no greater than the debtor had to give, absent a true avoiding power attack." (emphasis omitted)).

207. BAIRD ET AL., *supra* note 188, at 238.

208. 11 U.S.C. § 365(n)(1)(A) (2000).

209. *Id.* § 365(n)(1)(B).

complete property-contract parity,[210] but they do not go far enough to clean up the mess of case law occasioned by the current property-contract distinction.[211] Jackson, writing years before the addition of § 365(n), noted that the treatment of nondebtor-licensees of intellectual property under the "unthinking application of a right of rejection written into [old] section 365" was like no "outcome [that] could occur outside of bankruptcy."[212] After § 365(n) was added, Jay Westbrook noted that its effect is "close to what would emerge from functional analysis in [its] absence," but cautioned that Congress might have violated nonbankruptcy law in favor of the nondebtor party, possibly by mistake.[213] Thus, the addition of these provisions provides grounds both for hope that enlightened legislation can move bankruptcy closer to full acceptance of the principle of property-contract parity and for concern that legislation without solid policy foundations will not be able to avoid creating problems. It is my belief that a foundation of property-contract parity can partly allay this concern.

CONCLUSION

Contracts create property; contractual rights and obligations are property. This has long been recognized in nonbankruptcy law. In bankruptcy, however, for a variety of unpersuasive reasons, it is generally not recognized. Many facets of bankruptcy law serve to harm holders of contracts while treating holders of property with great deference. Rather than use a rational normative principle, bankruptcy instead often operates on a nominalist level—things that a court calls "contracts" are treated with less deference than things it calls "property." Bankruptcy law and policy should recognize the property in contract.

Following the property-contract-parity approach would lead to more consistent bankruptcy decisions, more deference to nonbankruptcy law, greater protection for valid party expectations, and less inequity between interested parties in bankruptcy proceedings. It is possible that Congress will continue to move bit by bit toward a better bankruptcy law, as it has with § 365(n), although adopting a clear and overarching policy

210. Ironically, because property-contract parity in bankruptcy follows the nonbankruptcy attributes of executory contracts, the result reached is virtually the same as that which would be reached if § 365 did not exist at all. *See* Andrew, *Reply*, *supra* note 63, at 17 n.74 (calling § 365(n) "unnecessary" because rejection should not destroy property rights); Westbrook, *supra* note 64, at 331 n.434 (calling § 365(n) "unnecessary to the extent [it] track[s] the proper result under nonbankruptcy law").

211. Jackson, discussing § 365(h), praises its nonbankruptcy-like results but complains that such results "should not depend on finding a special safe-harbor in the Bankruptcy Code." JACKSON, *supra* note 3, at 110.

212. *Id*. at 111, 110-11.

213. Westbrook, *supra* note 64, at 331 n.434.

justification might be better. In the bankruptcy courts, fundamental bankruptcy principles support reaching decisions based on property-contract parity. In most cases, this will not be difficult—courts can simply follow one line of precedent rather than another—but each such step moves us closer to a more consistent, more coherent bankruptcy law.